

EPHREM HABTEMICHAEL REDDA

North-West University, South Africa

PAUL-FRANCIOUS MUZINDUSTI

University of Kwazulu Natal, South Africa

DOES SADC CONSTITUTE AN OPTIMUM CURRENCY AREA? EVIDENCE FROM GENERALISED PURCHASING POWER PARITY

Abstract:

The Southern African Development Community (SADC) has ambitious plans of economic integration for the region. It is planning to introduce a common currency and a regional central bank by the year 2018. As advocated by the optimal currency area (OCA) theory, lower transaction costs, stable prices, efficient resource allocation and improved access to goods, labour and financial markets are some of the benefits accrued from monetary unions. Relinquishing monetary and exchange rate policies are cited as the main costs of joining such a union. It is argued that sufficient and sound economic bases should be in place for a monetary union to be effective and yield the desired result. The primary objective of this paper was to determine whether SADC constitute an OCA. The study employs the generalised purchasing power parity (GPPP) framework consistent with OCA theory on price (inflation rate) and exchange rate. The method included Johansen cointegration test, vector error correction model and Pedron's panel cointegration test. The findings of the study suggest that GPPP holds in SADC. This can be interpreted as existence of similarities of fundamental macroeconomic factors that drive real exchange rates in the region. This evidence suggests that bilateral real exchange rates in the SADC region share a common stochastic trend in the long-run. However, the differences in the size of coefficients of normalised long-run cointegrating equation suggest that the aggregate demand patterns in the region are dissimilar and indicate asymmetries in exchange rate adjustment process to disequilibrium in the region. Other economic concerns such as business cycle synchronisation, and convergence of key macroeconomic variables including budget deficit, government debt and foreign reserves cover should be thoroughly investigated before the said economic union is implemented.

Keywords:

Optimum currency area, generalised purchasing power parity, monetary union, single currency, SADC

JEL Classification: F33, F40, C23